

City of Rockville Retirement Board

October 5, 2006

PRESENT: Allen Gorrellick, Chairperson; John Sverha, Citizen Member; Anita McCombs, AAME Representative; Sgt. Tim Marsh, FOP Representative, Robert Dorsey, Councilperson; Catherine Tuck Parrish, Deputy City Manager. Also in attendance were Gavin Cohen, Executive Secretary to the Board; Rich Hajewski, Director of Personnel; Mary Johnson, Personnel Administrator; Tim Peifer, Financial Systems Manager, Alison Putnam, Principal Group, as well as George Kiriakos and Robert Liberto, Segal Advisors.

ABSENT: Joe Pritchard, Union Representative

The meeting commenced at 4:15 p.m. and started with introductions.

I. Approval of Minutes from June 15, 2006:

Mr. Gorrellick made a motion to accept the minutes as presented . Mr. Sverha so moved. All were in favor.

II. Review of Quarterly Performance Report April 1 – June 30:

Mr. Kiriakos gave a presentation of the investment performance of the regular plan through June 30, 2006. He started with a brief overview of financial market conditions during the second quarter of 2006. He stated that the stock market was particularly volatile through the end of June. Continued inflationary pressures in the US economy lead to two 25 basis point increases in the Fed Funds overnight rate, which now stands at 5.25%. Wages and rising housing costs contributed to inflation and geo-political events in the Middle East pushed crude oil prices to near-term highs. On the flip side natural gas reserves were high enough for prices to start coming down. The consumer price index rose 1.6% and the U S dollar continued to weaken relative to major world currencies.

Next Mr. Kiriakos went on to talk about the US economic conditions and that the key things to pay attention to revolved around the gross domestic product or the GDP, the measure of all goods and services produced in the US. What the Federal Reserve was looking to do with 17 consecutive interest rate hikes was to slow the GDP and they managed to accomplish that. GDP came in at 5.6% in the first quarter and came down to 2.5% in the second quarter. Just by way of a benchmark the GDP usually runs below 3% historically. It was below the consensus estimate of 3.1%. That is another thing to look out for, whether or not it comes in below or above expectation. Reasons for the weakness in growth during the second quarter was a decline in personal consumption, capital expenditures, and exports. Other reasons for the weakness was that inventory investment remained low and private residential investment fell for the first time in three years. The housing market continued to decline, as sales of existing homes dropped 1.3 % during the month of June.

Next we break it down as to what has gone on in the equity and fixed income markets. What you are looking for there is what did well such as small cap or large cap growth. At the end of the second quarter the broad result was that stocks gave back some of their first quarter gains. Large-company stocks outperformed smaller-cap issuance. Energy stocks again were the strongest performing sector. The weakest performing sector was Technology. The Materials and Services sector was an underperformer too.

On the fixed income side you are looking at a period of Federal tightening. Good news is that in the last two meetings the Feds decided to leave rates alone. It is good news for bonds and the stock markets. The bond market is down on a year to date basis through June.

In the global market the pullback in stocks and bonds was a global phenomenon in the second quarter of 2006. Most markets gave up first quarter gains. The weak US dollar turned some losses into gains for US based investors. Global bond markets yielded results that were similar to stock markets; developed market underperformance was offset by strong currencies relative to the US dollar and emerging markets weakened due to widening spreads relative to US Treasuries.

Mr. Kiriakos then went on to explain the indexes. Mr. Cohen inquired which one do we use as our benchmark and Mr. Kiriakos said that we use the S&P for stocks and the Aggregate for bonds. The S&P was up 2.7% year to date. We know it was a negative 1.4% for the second quarter so we know it was a fairly good first quarter. It tacked on about 5% in the third quarter. The Russell 3000 Index is what is viewed as a total market index because it encompasses both large and small cap growth and value stocks. Russell then breaks that index down into various components based off the Russell 1000, which generally deals with large cap issues and then the Russell 2000, which deals with the smaller names in that composite 3000 index. The value stocks did significantly better than the growth stocks the first part of the year. The value stocks do better when things are not good and the growth stocks do better when things are good. Maturity is the key for investing this year. Mr. Kiriakos went on to explain the rest of the charts.

Mr. Sverha asked if Principal vary the allocation based what they see in the market. Ms. Putnam responded that they take direction from the City. Mr. Cohen said that is a perfect question that leads to the rebalance. Mr. Sverha said that most people rebalance by moving the new contributions into the account that need to be adjusted. Mr. Kiriakos said that he preferred monies going in and out according to the target allocation. Mr. Cohen stated that the Board makes the decision as to how the rebalancing is done and that the City does rebalancing with new money once a year. It is usually done in March and the Board can meet to decide and is it more beneficial to do the balancing more often? Mr. Cohen asked Mr. Kiriakos how do you arrive at the target allocation? Mr. Kiriakos responded that they tend to look at it two times per year and will provide four reports per year and will give recommendations to rebalance when they see the need. Mr. Cohen asked if the benefit was to keep within the guidelines or overall returns? Mr. Kiriakos said that the asset allocation study is to look for prediction to target. In the long run rebalancing is generally beneficial. Mr. Liberto said that this is how anyone should take care of his or her own portfolio. Mr. Gorrellick asked if advice on investment mix is part of the contract with Segal. Mr. Cohen responded yes. Asset allocation should be done at least once every three years. Principal manages all three pieces, Principal-Large Cap Equity, Principal-International Equity, and Principal-Fixed Income. Mr. Liberto asked if 50 basis points is in line overall for a plan this size. Mr. Kiriakos said yes it was very much in line. Mr. Gorrellick asked Ms. Putnam is Principal could provide Gavin with a breakout in fees? Ms. Putnam said that Principal could provide a revenue disclosure to show just what the breakdown is. Mr. Gorrellick said that way Mr. Cohen can see if management fees are reasonable. Sgt. Marsh wanted to know when the last allocation study was done. Mr. Gorrellick replied about five years ago. Mr. Kiriakos said that this could be looked at sometime early next year.

Mr. Kiriakos continued to go through the report and go over the charts. As of June 30, 2006, the Plan's assets were valued at \$55.9 million, which was a decrease of \$1.0 million from the last quarter. The decrease was due to investment losses of about \$0.5 million in addition to \$0.5 million of net withdrawals from the Fund. At the end of the quarter the asset allocation was 54% domestic equity, 15% international equity, and 32% fixed income and cash equivalents, which was in line with the Plan's guidelines. Over the quarter, the Total Fund trailed the policy index and placed in the third quartile of the balanced manager universe. Principal's large cap equity portfolio marginally underperformed the S&P 500 Index for the latest quarter. Principal's international equity portfolio trailed the MSCI NET EAFE Index for the most recent quarter and placed in the second quartile of the foreign equity manager universe. Principal's fixed income portfolio marginally underperformed the Lehman Aggregate Bond Index for the latest quarter and placed in the bottom quartile of the core fixed income manager universe. He then went on to the chart on page 8 and said not much has changed since the end of last quarter. He went on to explain what each of the charts mean and what you should be looking for. He said you should have standing instructions for cash flow. Ideally to stay within target allocations you should distribute monies proportionately. Mr. Gorrellick asked who controls where the money comes from? Ms. Putnam said that the City provides the instructions. Mr. Kiriakos stated that the standard rule should be monies coming in and going out should be handled proportionally, 50 15 35 split. Mr. Cohen will send that instruction in writing to Principal. Sgt. Marsh made motion to that all inflows and outflows will be treated on a proportionate basis on the target allocation and that staff will coordinate with Principal. All were in favor. Mr. Kiriakos continued explaining the charts. Page 13 is how the fund would look if the asset allocation was done by 50 15 35 split. He said our plan was very close to this. He said we are comfortably above average. The key to our success is winning by not losing in the long term and why we are ahead of the game in the long term. It is all in the way the math works. Mr. Cohen asked if our risk scale for this portfolio is pretty conservative? Mr. Kiriakos responded that it is fairly moderate.

Discussion continued as to the future of retirement plans and the different types that will be created.

Mr. Kiriakos continued to explain the rest of the report, and stated that it is fairly straightforward. The rest of the report is charts explaining our portfolios performance separated individually. Mr. Liberto stated that it is clear that Principal has done very well as your investment manager.

Mr. Liberto now went on to explain his report. He stated that Segal sent Gavin new guidelines that will not be discussed today. He would like the committee to receive copies. Mr. Cohen concurred and said that would come to the board for formal recognition and adoption at the next meeting. It was discussed that there should be separate documents for each pension plan. Mr. Kiriakos stated that this document would not be ready for the next meeting if something changes between now and then. Mr. Kiriakos was very pleased with Principal's Life Cycle Funds. He said there has been very solid performance and would recommend adding it to the portfolio. He also would recommend using the Life Cycle Funds as the default fund if they get added and put people into the appropriate one based on their age. This would only pertain to people who have not made a selection. Mr. Gorrellick inquired if there was room in the contract to add another fund? Ms. Putnam said there was, they allow for 21 funds. Mr. Cohen stated that it would come back to the Board for formal discussion and acceptance to add the Life Cycles Fund to the fund selection at the December meeting. Mr. Liberto stated that he was disappointed in how the stable value account did. He said it underperformed other clients stable value accounts.

Mr. Liberto continued with his presentation. He stated that the opening balance in the Defined Contribution Plan was \$12.1 million and at the end of June the assets were \$12.7 million. That was an increase of approximately \$600,000 and the bulk of it came of net contributions. About 40% of the money flows into the Principal Guaranteed Interest Account. As of June 30, 2006, the Principal Large Cap Stock Index Account held the largest percentage of Plan assets at 17.5%, followed by the Principal Guaranteed Interest Account (15.1%), and the Principal Money Market Account (14.9%). He said that our employees are doing a great job with their asset allocations. The funds that held the highest percentage of new contributions during the quarter that ended June 30, 2006 were the Principal Guaranteed Interest Account (60.1%), Principal Money Market Account (12.0%), and the Principal Large Cap Stock Index Account (5.7%). These funds represent over 50% of the assets in the Plan. Mr. Liberto said that Segal could not recommend anything to us regarding the Stable Value Account until they understand how the product works. Mr. Cohen asked what criteria are we using to determine when to dump the fund? Mr. Liberto responded how it does in a 3-5 year cycle. Ms. Putnam said it is a blended gic fund and there is one at a two year and one at a seven year and they are general accounts. Mr. Liberto said he and Principal would look at it and other products they have and it may be worth changing the product. He went on to discuss how the funds have performed. Mr. Cohen asked if that was the criteria to decide which products to keep or let go? Mr. Gorrellick said that this had been done before because they wanted to reduce the choices. Mr. Kiriakos stated that the Board's fiduciary responsibility is to act in the Participants or Plan's interest. Mr. Liberto said that if you decide to close a fund you just have to give notice to the participants and map the funds over. Mr. Gorrellick asked what is the difference between the Principal Large Company Growth Account and the Principal Large Cap Account? Mr. Liberto said one is more aggressive than the other and that they are both concentrated portfolios. They are two different funds and one does a better job of stock picking than the other. Ms. Putnam said they are also different managers. Sgt. Marsh questioned if it was a fee related issue if you closed a fund and mapped it over? Mr. Liberto responded that there was not. Mr. Gorrellick confirmed that the performance fees were net of expenses. Mr. Kiriakos said that the argument goes that if you choose an actively managed fund it should outperform enough to pay for its fees. Sgt. Marsh questioned if Segal was prepared today to make some recommendations about some of these funds? Mr. Liberto said yes. He continued going through the report. He said that the expense ratios are very low for a plan of this size. He said that Principal has done a good job of providing plenty of decent funds with low expense ratios. Ms. Putnam that she wanted to point out that the Stock Emphasis Balanced Account in particular was the first one that came with both a bond and a stock emphasis. Mr. Liberto said to always keep an eye on funds that under perform significantly. Mr. Cohen asked if Mr. Liberto could summarize which funds you would eliminate and which ones you would get keep an eye on? Mr. Liberto responded that you would keep an eye on the Vanguard Windsor II Fund, Segal recommends eliminating the Principal Partners Large Cap Growth Account and mapping the assets into the Principal Large Company Growth Account. We recommend eliminating the American Century Small Value Fund and mapping the assets to the Principal Small Company Value Account. Overall the plan has done very well. We are going to investigate with Principal other products in the Stable Value line. Mr. Cohen said the Board would come back again and take formal action on these items and as part of that in terms of having a default fund it will be based on what is decided with the Life Cycle Funds. If they are added they can be considered the default funds. Mr. Cohen asked is that something that the Board would recommend happening? In respect to the changes in funds would it be the Boards recommendation to dump them and map them? Mr. Sverha said that would be his preference. Sgt. Marsh clarified that the Life Cycle funds would be both a default fund and a choice. Mr. Cohen asked is there a preference for Sunsetting or just closing and moving over? Mr. Sverha felt

Sunsetting would be in the participant's best interest. Ms. Putnam asked do they typically use 6 months? Mr. Liberto said some clients are six months and some are shorter. You can use any time frame you like. Mr. Liberto said there are 53 people in one fund and they get concerned when there are a large number of people in one fund. He suggested that Principal give these 53 people communication about asset allocation. Mr. Gorrellick asked is there a number that you like to see in a fund? Mr. Liberto said that they just want to see diversification. Mr. Putnam told Mr. Liberto that they hold meetings on a regular basis and just recently had a meeting on DC/DB so they could better explain the Defined Benefit Plan. What she would suggest is that they do an asset allocation mailing to all of the plan participants because of these 53 some may be in the stock balance portfolio there may be very good reasons for the selection they have made and we have 42 employees that have 9-10 funds and wonder if that is the best choice also. Mr. Liberto would like to see more of a breakdown as to which funds the participants are in. Ms. Putnam said that could be provided. Ms. Tuck Parrish said that if there is any condensed information that would reinforce your message and get people to use the website could you provide it. Ms. Putnam responded that she has found post cards to be effective and that they have an excellent one-page article on asset allocation. With the Defined Benefit statement that just went out there was an article on using the Internet. Mr. Liberto said the numbers are very good and it seems a lot of people are getting the message. Mr. Liberto would like to see different workshops set up such as retirement and preparing for it and Investing 101. Ms. Putnam said there are a few challenges such as different work groups like the Police and the Union employees. For the Union employees it would have to be very early in the morning. She said that she could get together with Mr. Peifer and arrange it again. Mr. Cohen suggested coordinating it with the new trainer. Sgt. Marsh was curious how many people are we reaching and is it the same people or different people each time? Mr. Kiriakos said you have to just get more creative in how you deliver the information such as DVD's. Sgt. Marsh said this information is very difficult for the average person to understand. Ms. Putnam said they also have webinars for those who cannot make it to the meetings or to help the spouses get involved. Mr. Cohen said that the chief would prefer to get all the information that needs to be distributed to the Police. The information regarding the choice of percentage selection needs to be given to the employee at the time of hire because it is a one time selection due to an IRS regulation.

III. Educational Component – Board Members Fiduciary Duties and Responsibilities:

This item was deferred until June.

IV. Board Members Liability Coverage:

This item was deferred until June.

V. Pension Protection Act, 2006:

This item was deferred until December.

VI. Discussion for Future Agendas:

- Segal checked their calendars to see when to have the next meeting. The dates that were good for Segal were December 4th and 8th and to hold it at an earlier time in the day. Mr. Cohen said he would send an e-mail notifying everyone when the date was finalized. Ms. Tuck Parrish said that Mr. Ullery had called during the meeting and asked the Board to consider at a future meeting the issue of portability in terms of recruitment. The Board decided to start the next meeting at 10:00 a.m.
- Review of April 1, 2006 Actuarial Valuation Report with changes – Principal
December
- Retiree Cola for 2007 – Staff
December
- Review of quarterly performance report July 1- Sept 30 – Segal Advisors
December
- Review of Plans Investment Policy – Segal Advisors
June
- Review of Funds Thrift Plan – Segal Advisors
December

- Review of Educational Topic – Staff –
- Review information received by Retirees – Tim Marsh
Gavin will take care of
- Review of Plan Document – Staff - Ongoing will be posted to website
- Review of Changes to Plan based on PPA 2006 – Staff
December

A motion to adjourn the meeting was made by Sgt. Marsh at 7:10 p.m.